

**DEPARTMENT OF STATE REVENUE  
LETTER OF FINDINGS NUMBER: 97-0250  
ADJUSTED GROSS INCOME TAX  
For Years 1992, 1993, and 1994**

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**ISSUES**

**I. Adjusted Gross Income Tax – Investment Income as Non-Business Income:**  
Mutual Fund Proceeds

**Authority:** IC 6-3-20; IC 6-3-1-21; IC 6-8.1-5-1; 45 IAC 3.1-1-29; 45 IAC 3.1-1-30; 45 IAC 3.1-1-59; Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207 (1980).

Taxpayer protests the auditor's determination that dividend income, received from taxpayer's mutual fund investment, is properly classified as business income.

**II. Adjusted Gross Income Tax – Computation of Income Tax Addback:** Taxes  
Based on Income

**Authority:** IC 6-3-2-1(b); IC 6-3-1-3.5(b); IC 6-3-1-3.5(b)(3); I.R.C. § 63.

Taxpayer protests the auditor's determination that taxpayer did not properly compute Indiana adjusted gross income because taxpayer did not include in the computation of the income tax addback all taxes based on income expensed in computing federal income tax.

**STATEMENT OF FACTS**

Taxpayer is a wholly owned subsidiary of a German corporation. Taxpayer's principal production facilities are located in South Carolina. During the audit period, taxpayer had no Indiana location or operations. Taxpayer maintains inventory in the state on consignment or for further processing by unrelated operations. The inventory is eventually shipped to taxpayer's warehouse out of state or sold out of state by the consignor. Taxpayer manufactures automobile parts and car radios. Taxpayer's subsidiary groups operate vehicle repair shops, build high technology packaging

machinery, manufacture small household appliances, and manufacture thermal and electro-chemical deburring and deflashing equipment for the plastics industry.

**I. Adjusted Gross Income Tax – Investment Income as Business / Non-Business Income: Mutual Fund Proceeds**

**DISCUSSION**

In September of 1987, taxpayer's executive vice-president received a First Eagle Fund of American prospectus. After reviewing the information, the vice president instructed the treasurer to wire transfer \$1,000,000 in cash to purchase approximately 85,000 shares of the fund. Taxpayer has since maintained its long-term position in the fund for ten years. Taxpayer contends that the dividend income derived from the First Eagle Fund is non-business income for the purpose of computing Indiana Adjusted Gross Income Tax. Taxpayer argues that the dividend income arises from the acquisition and holding of a passive investment in a mutual fund unrelated to the taxpayer's primary business of manufacturing and distributing automotive component parts.

The auditor found that taxpayer had treated interest income from the First Eagle Mutual Fund as non-business income for two years of the audit period. The receipts were included in the denominator of the sales factor as filed by the taxpayer. The auditor determined that, because the interest income had been earned upon funds generated by taxpayer's business operations, the income should be treated as business income pursuant to 45 IAC 3.1-1-59.

IC 6-3-1-21 defines the term "non-business income" as "all income other than business income."

Under 45 IAC 3.1-1-59, interest income is non-business income if the intangible with respect to which the interest was received did not arise out of or was not created in the regular course of the taxpayer's trade or business operations or where the purpose for acquiring and holding the intangible was not related to or incidental to such trade or business operations.

IC 6-3-1-20 defines "business income" as all "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations."

For the purpose of determining where interest was created in the "regular course" of taxpayer's business, (See 45 IAC 3.1-1-59, IC 6-3-1-20) the expression "trade or business" is not limited to the taxpayer's corporate charter purpose of its principal business activity. 45 IAC 3.1-1-30. A taxpayer may be in more than one trade or business and derive business therefrom depending but not limited to some or all of the following:

(1) The nature of the taxpayers' trade or business. (2) The substantiality of the income derived from activities and transactions and the percentage that income is of the taxpayer's total income for a given tax period. (3) The frequency, number, or continuity of the activities and transactions involved. (4) The length of time the property producing income was owned by the taxpayer. (5) The taxpayer's purpose in acquiring and holding the property producing income. From the above language, it is apparent that the criteria to be used in determining a taxpayer's trade or business is not limited by what the taxpayer purports its business to be but rather on what the particular facts and circumstances show.

45 IAC 3.1-1-29 provides further guidance. The initial classification of income by common labels is of no aid in determining whether income is business or non-business income. Instead, "[i]ncome of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'non-business income' is the identification of the transactions and activity which are the elements of a particular trade or business."

The significance of the business/non-business distinction lies in the method of calculating taxpayer's adjusted gross income tax. For purposes of determining that tax, if taxpayer's mutual fund income constitutes business income, that income is apportionable to Indiana. If the income is non-business income it is not allocable to Indiana because taxpayer is not commercially domiciled in Indiana.

Applying the five determinative factors provided in 45 IAC 3.1-1-30 yields the following results:

1) Taxpayer is in the business of manufacturing car parts, operating car repair shops, producing manufacturing equipment, and manufacturing small appliances. In contrast, the circumstances surrounding the initial decision to make the First Eagle Mutual Fund investment tend to support a conclusion that the decision to make this long term investment was outside of taxpayer's normal business practices and procedures. The investment decision was a unilateral executive decision, made without consideration of taxpayer's business aims or needs, and without regard to how the investment would necessarily affect taxpayer's business goals.

2) The \$1,000,000 investment represents an investment of approximately 1% of taxpayer's annual taxable income.

3) Taxpayer's initial decision to make the investment represents one of the few "transactions" which occurred during the ten years taxpayer has maintained that investment. Except for presumptive periodic decisions to retain the investment, the nature of any mutual fund investment precludes the possibility that taxpayer managed, participated in, or played any decision making role in the day-to-day operation of the investment.

4) Taxpayer has maintained an uninterrupted investment in the First Eagle Mutual Fund for ten years.

5) Although taxpayer offered no specific purpose underlying its decision to invest in the mutual fund, the available information would tend to support a conclusion that the investment's purpose was ancillary to taxpayer's primary business goals.

Therefore, given the nature and purpose of taxpayer's business operations, the relatively small size of the investment, the passive role taxpayer played in managing the investment, and the long-term commitment taxpayer made to the investment, the circumstances surrounding taxpayer's mutual fund investment tend to support a conclusion that the interest derived from that investment is properly classified as non-business income.

45 IAC 3.1-1-59 Example 7 is instructive and would support that conclusion. In that example, a multi-state manufacturer purchased and maintained a portfolio of interest bearing securities for investment purposes. The interest from those securities was deemed non-business income. Similarly, taxpayer made an investment in securities, the investment was ancillary to taxpayer's business goals, and the investment was maintained without day-to-day participation on the part of taxpayer.

The burden of proving that the proposed assessment is erroneous rests with taxpayer. The auditor's adjustment is accorded prima facie validity. *See* IC 6-8.1-5-1. The Supreme Court places the burden of proof on the taxpayer to show by "clear and cogent evidence," Exxon Corp. v. Wisconsin Dept. of Revenue, 447 U.S. 207, 221 (1980), that "the income was earned in the course of activities unrelated to [those carried out in the taxing] state." Id. 223. Taxpayer has met its burden of demonstrating that the income derived from its mutual fund investment is properly classified as non-business income.

### **FINDING**

Taxpayer's protest is sustained.

## **II. Adjusted Gross Income Tax – Computation of Income Tax Addback: Taxes Based on Income**

### **DISCUSSION**

Taxpayer protests the auditor's determination that taxpayer did not properly compute Indiana adjusted gross income because it did not include in the computation of the income tax addback all taxes on income expensed in computing federal income tax.

Indiana adjusted gross income tax is imposed upon the adjusted gross income of a corporation derived from Indiana sources. IC 6-3-2-1(b). Under IC 6-3-1-3.5(b), Indiana adjusted gross income, in the case of corporations, is same as taxable income as defined

by I.R.C. § 63 and adjusted according to IC 6-3-1-3.5(b)(3). IC 6-3-1-3.5(b)(3) requires the addback of taxes based on or measured by income and levied at the state level.

In particular, taxpayer argues that taxes it paid in Arizona, California, Delaware, Georgia, Illinois, Iowa, Massachusetts, Michigan, Minnesota, New Jersey, Pennsylvania, South Carolina, Tennessee, and Virginia were taxes not assessed on the basis of taxpayer's income and, therefore, should be excluded from the computation of Indiana adjusted gross income tax. Taxpayer characterizes these taxes as either filing fees, or taxes based on capital stock, gross receipts, apportioned net worth, state property, payroll, or sales. To the extent that these individual state taxes were not based on measured by taxpayer's income, taxpayer's protest is sustained. Audit is requested to conduct a supplemental audit to verify that these taxes were not assessed on the basis of taxpayer's income.

### **FINDING**

Subject to verification by audit, taxpayer's protest is sustained.